

VZCZCXRO9352
PP RUEHAG RUEHDF RUEHIK RUEHLZ RUEHROV RUEHSR
DE RUEHLO #0871/01 1041439
ZNR UUUUU ZZH
P 141439Z APR 09
FM AMEMBASSY LONDON
TO RUEHC/SECSTATE WASHDC PRIORITY 1973
INFO RUCNMEM/EU MEMBER STATES COLLECTIVE PRIORITY
RUCPDO/DEPT OF COMMERCE WASHDC PRIORITY
RUEATRS/DEPT OF TREASURY WASHDC PRIORITY
RUEHBL/AMCONSUL BELFAST PRIORITY 1284
RUEHED/AMCONSUL EDINBURGH PRIORITY 1114

UNCLAS SECTION 01 OF 02 LONDON 000871

SENSITIVE
SIPDIS

E.O. 12958: N/A
TAGS: [ECON](#) [EFIN](#) [ETRD](#) [EINV](#) [UK](#)
SUBJECT: FAILED BOND AUCTION RAISED CONCERN OVER UK'S BORROWING
PROGRAM, BUT PICTURE SLIGHTLY BRIGHTER NOW

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11. (SBU) The UK is borrowing its way out of recession. HMG aims to sell a record GBP 146.4 billion of debt this fiscal year and as much as GBP 147.9 billion in 2010 to pull the UK out of its worst recession since 1980. An undersubscribed gilt auction on March 25 triggered great concern in the government about investor-readiness to support the government as it takes on record debt. However, gilt auctions since then, both short-and-long-term, have been fully subscribed, easing, at least temporarily, government concerns.

Borrowing to Recover -----

12. (SBU) The UK's economic downturn has strained public finances. Lower tax revenues and higher spending on recession-related benefits have left a hole in the public purse that will be partly filled by borrowing. HMG plans to sell a record level of debt in the next two years. A report by the influential Institute for Fiscal Studies predicted that the total burden of outstanding government debt may continue to rise for the foreseeable future. It estimated the total stock of government debt, which already exceeds HMG's previous self-imposed ceiling of 40 percent of GDP, could double to more than 80 percent by 2016.

Bond Auction Fails -----

13. (SBU) Four months ago, the chief executive of the UK's Debt Management Office (DMO), which oversees auctions of UK government bonds (gilts), warned of the possibility of failed bond auctions, given the record amount of debt to be sold. His prediction came true on March 25, when the UK government, for the first time in seven years, failed to find enough buyers for a GBP 1.75 billion gilt auction. Investors bid for GBP 1.63 billion of the 40-year bonds, leaving a shortfall of GBP 120 million. The last time a gilt auction received less than 100 percent demand was in 2002 when an inflation-linked auction failed. There has not been an undersubscribed conventional gilt auction since 1995. On news of the failure, gilt prices slumped and the pound weakened against the U.S. dollar and the euro. Media commentators said the gilt failure further undermined the Prime Minister's reputation for economic competence and compared it to the 1995 gilt auction failure under John Major's struggling government.

14. (SBU) The lack of demand is partly explained by concern over the state of public finances as government borrowing rapidly increases. This concern over public finances was fuelled by comments by the Governor of the Bank of England (BOE), Mervyn King, who told the House of Commons' Treasury Committee that the UK's fiscal position would not support another round of significant fiscal expansion - putting in question how much the UK could borrow. Prior to the gilt auction, CPI inflation figures were released, showing an unexpected uptick, and as a result, eroded the value of bonds. Additionally,

the 40-year bond fell outside the BOE's quantitative easing gilt purchase program, which will buy up to GBP 75 billion of gilts and corporate bonds in maturities between five and 25 years. The price of gilts that fall under the BOE's program will be artificially supported by the Bank's purchases - making other bonds less desirable. While newspapers and several economists called the failure of the gilt a blow to HMG's borrowing plans, HM Treasury denied that the auction's failure reflected any wider difficulty in funding the UK's budget deficit.

One-Off Timing Mishap?

15. (SBU) HMT has been right, so far. It has been business as usual since the March 25 auction, according to Steve Whiting, the Debt Management Office's policy adviser. Whiting told us the DMO was reassured by the April 2 auction when all GBP 2.25 billion of 30-year bonds were sold. The sale had 1.59 times as many bids as securities offered. He said the March 25 auction was no more than a failure of the market to find an appropriate clearing price for the debt on offer on a particular day. He added that market conditions are very volatile, particularly following the introduction of the BOE's quantitative easing program, and that in these conditions, failures can happen. He said the 40-year bond is one of the riskiest bonds the DMO sells and that this, combined with the record volumes of debt the DMO is auctioning, partially explains the failure. He cautioned that while one or two auction failures will not raise any particular concerns, a series of uncovered auctions might require a revision of the DMO's plans.

16. (SBU) Comment: While the failure of the UK gilt auction was surprising and raised fears about HMG's ability to fund its ballooning deficit, it may not have any long-term significance. The UK bond market is unusually volatile at the moment and so is likely to throw up some surprises. If the auction failure was repeated,

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serious questions would be asked about the credibility of HMG's borrowing program. However, this single auction should not promote concern about the country's ability to fund itself. Similarly, a one-off auction failure is unlikely to seriously dent the Prime Minister's standing, but a series of failures could be damaging and would highlight a serious lack of investor confidence in the British government.

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